Moscow Financial Weekly

For the week ending May 24, 2002

Treasury Attache's office, US Embassy Moscow

Highlights

- New announcements regarding the break-up of Vnesheconombank .
- Tax receipts down but reserves up.

Weekly focus: Text of the Report of the U.S. Russia-Banking Dialogue

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R31.2850	0.10	3.81
Monetary Base*	R742.1 bln	0.38	4.74**
CPI	NA	NA	6.6
International Reserves*	$40.6 bln	1.50	11.23
RTS Index (end of week)	402.89	-4.00	54.93
Refinancing rate	23	0	4

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

This week Goskomstat released April economic statistics, showing that domestic **demand is still a strong driver of economic growth**. Real income was up 10.9% m-o-m, and 12.6% y-o-y. Average per capita income was up 13.1% to $118 per month, and a full 34.3% y-o-y. Real wages fell 2.1% m-o-m, but increased 18.1% y-o-y. In addition, retail trade in April was up 9% y-o-y, with food and non-food commodities making up the bulk of this growth.

In terms of supply, **industrial production** was up 4.3% y-o-y in April, reflecting a continuation of the positive trends in the economy seen in March. Higher external demand and higher prices for Russian's natural resources was one of the major drivers of the increased production in sectors such as oil. At the same time, however, industrial growth was accompanied by an unexpected spike in PPI (6.8%), the biggest one-month increase over the past 18 months. This can be attributed to the increase in electricity tariffs for some producers, such as the agricultural sector.

However, **tax receipts** were down for the first four months of 2002. Finance Minister Kudrin said that federal revenues fell short by R17 billion ($440.4 million), and if this shortfall was not made up during 2002, the financial reserve fund would have to be debited by this amount. Lower VAT receipts due to higher refunds on exports was one reason. Profit tax receipts were also down. While it is difficult to assess exactly how the new profit tax is working, a fall in corporate profits indicates that companies may be taking advantage of more generous deductions under the new law. The probability that this trend will cause serious problems for the overall budget picture in 2002 is quite low, especially if oil prices continue to average near the 2002 budget assumption of $23.5 per barrel. In June, the oil export tariff will nearly double from – to – Euro/ton based on higher prices which should significantly help improve the revenue picture The federal budget surplus for first quarter 2002 was 3.3% of GDP.

According to CBR Chairman Sergey Ignatiev, by the end of 2002, foreign exchange reserves will just "insignificantly exceed the current level." Last Wednesday, Ignatiev stated that at the end of this year the CBR might deliberately sell a part of reserves in order not to allow sharp depreciation of the ruble and acceleration of inflation. This would counteract the trend seen in past years when budget recipients withdrew all funds from their Treasury accounts at the end of December, resulting in a significant increase of rubles in circulation (10-11% between December 1 and January 1, 2001). This led to additional pressure on the ruble and accelerated inflation.

Banking sector

The **Russia-US Banking Dialogue** submitted its report to Presidents Putin and Bush during the Summit last week. The report, put together by private sector and foreign banks in Russia, summarizes discussions over the past six months on ways the government/CBR reform plan could be strengthened, and includes specific recommendations on lending to small business, state banks/competition, reducing the regulatory burden, and making the system compatible with international norms. At the meeting with the presidents, representatives described the Dialogue as the first time real private sector bankers had been able to come up with their own reform policy wish-list. Participation of Andrei Koslov, prior to his becoming Deputy CBR Chairman, insures a good hearing for the recommendations at CBR. The Dialogue plans to continue its work by organizing periodic meetings with CBR and among foreign and Russian bankers. We have included the final English version of the report at the end of the Weekly. The Russian version was published in Vremya on May 29th.

According to Denis Mikhailov, Head of the Minfin's External Debt Department, the Finance Ministry, in coordination with the CBR and Vnesheconombank (VEB), will finish drafting a **Federal Law on state debt management** by the end of this year or beginning of 2003. The Agency for State Debt Management will be created by the same pattern as the Agency for Restructuring Credit Organizations (ARCO); ie. a state corporation; and may become operational in 2004, Mikhailov said. This announcement represents a major shift from earlier reports that anticipated that management of both external and internal debt would be handled by MinFin.

Deputy Prime Minister and Finance Minister Alexey Kudrin submitted to the GOR a package of documents providing for transformation of the commercial part of **VEB** (of the ex-USSR) into so-called Vnesheconombank of Russia. In another major shift, the documents anticipate a subsequent merger of the latter with Vneshtorgbank (which is to be passed by the CBR to the GOR by the end of this year). The prior assumption was that VEB would merge with the state-owned Roseximbank. Reportedly, this plan has been coordinated with Prime Minister Mikhail Kasyanov, the CBR, and the Presidential Administration.

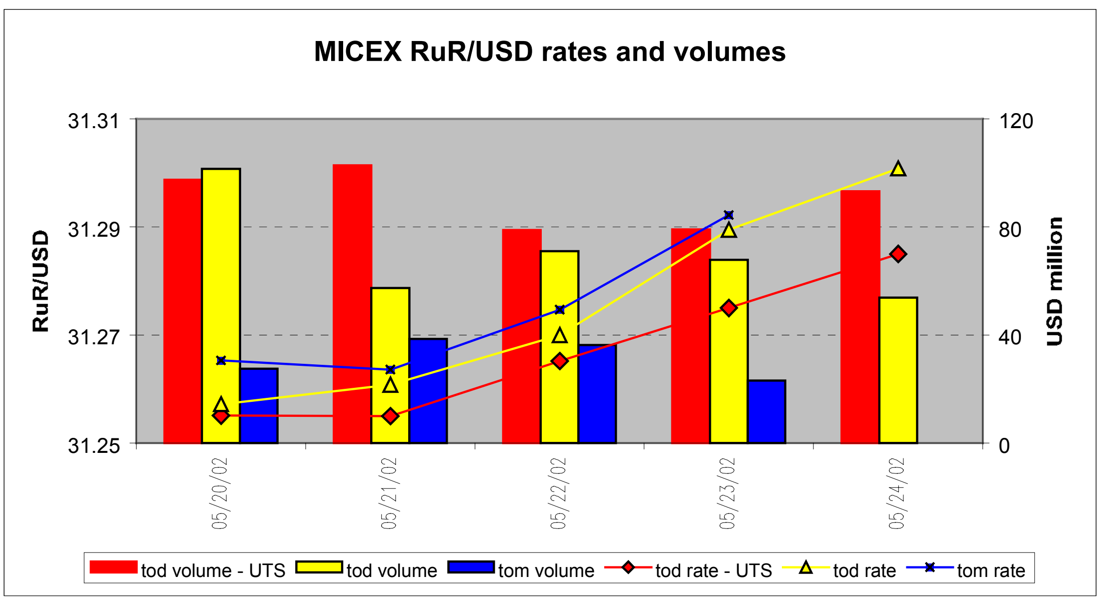
According to Vedomosti, if the merger happens the new bank would have assets of $6 billion and capital of $1.8 billion. Most likely, current VEB Chairman Andrey Kostin would head it, according to press speculation. It is not clear when the merger would take place, or the implications for plans to sell stakes in VTB to EBRD and other strategic investors. Not surprisingly, the news caused a strong negative response by VTB management. According to VTB President Yury Ponomarev, Minfin's new plan hinders "essential economic interests of the state." Given all of the twists and turns in this saga, recent announcements may not be the last word on this issue.

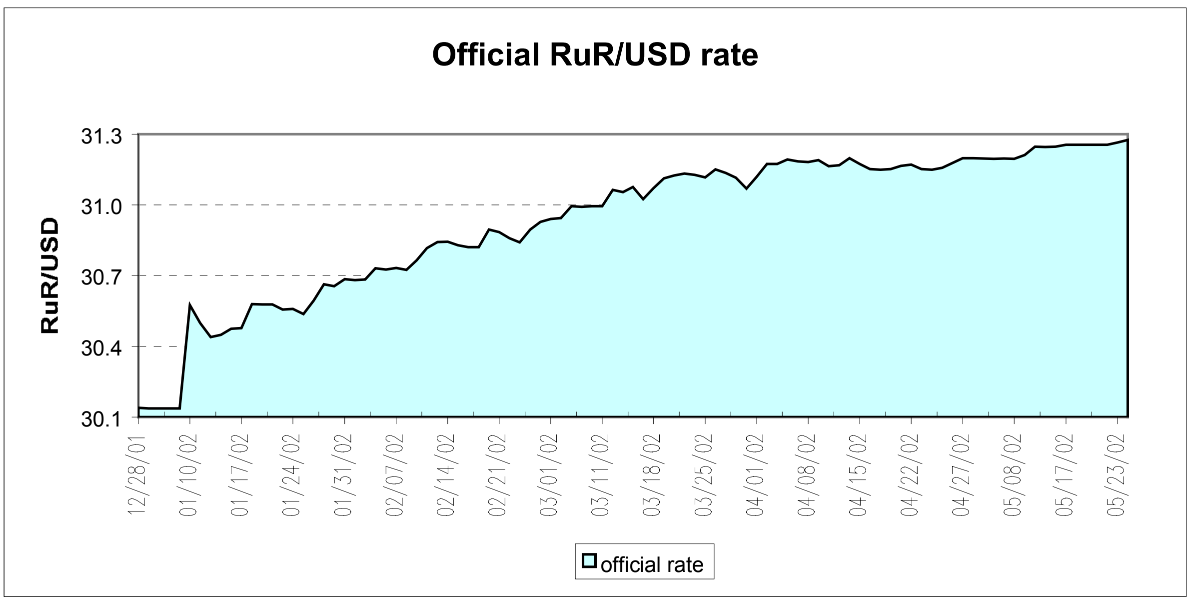
Financial markets

Forex Market

Last week the currency market remained dull. During the first 2 days of the week the exchange rate remained virtually unchanged, but from Wednesday the ruble started weakening against the dollar at the pace of 1 kopek a day. Banks' demand for dollars inched up with the growth of correspondent account balances with the CBR. However, CBR purchases of dollars in the MICEX UTS still remained the main factor in exchange rate dynamics last week.

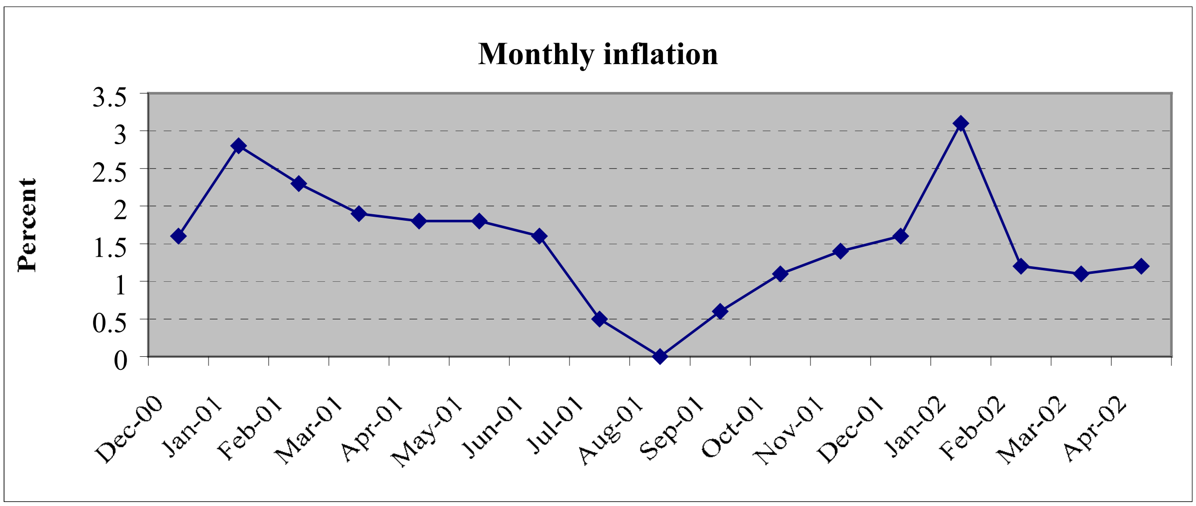
For the week the ruble depreciated 0.10% in nominal terms, closing in the UTS on Friday at R31.2850/$. MICEX weekly trade volumes were $451.37 million, $351.57 million and $125.58 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





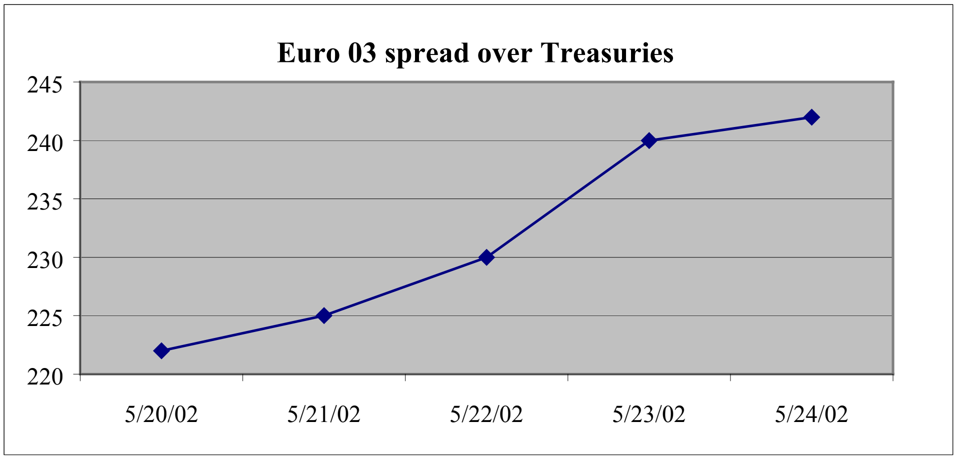
<u>Prices</u>

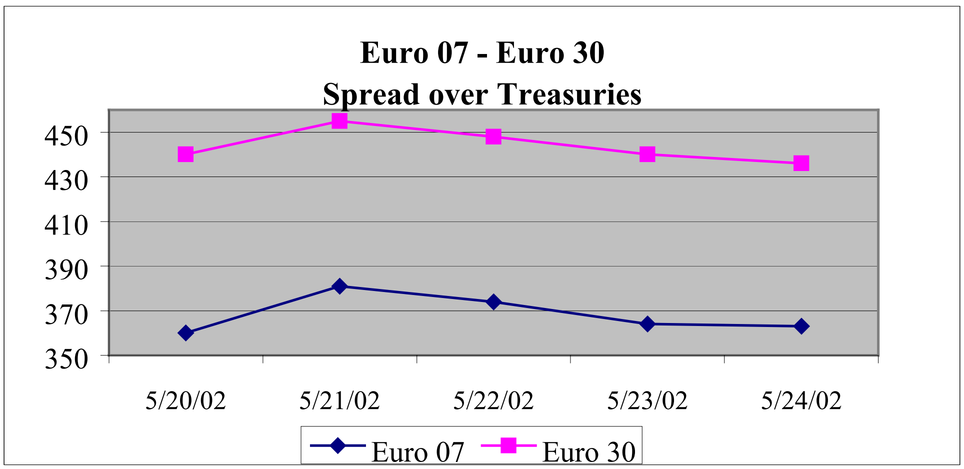
The rate of inflation was 0.8% for the first 20 days of May, a slight increase over last month. However, the annual rate of inflation for 2002 seems to be tempered from earlier in the year, though still above government projections.



Eurobonds

The Russian Eurobond market continued to grow last week, albeit at a slower pace, given residual market reaction to record reserve levels and recent upgrades. The Ministry of Finance announced late last week that Russia's external debt as of April 1, 2002, was $128.1 billion. Further good news from the market perspective was an announcement by Deptuy Finance Minister Bella Zlatkis that the government plans to introduce certain amendments to existing legislation to allow larger sub-federal borrowing programs, which would include Eurobonds. The Finance Ministry also indicated that they will issue Eurobonds later this year to settle part of the ex-USSR's trade credits, although issuance will wait until approximately $1 billion of the debt has been reconciled with creditors (approximately $500 million has already been verified).

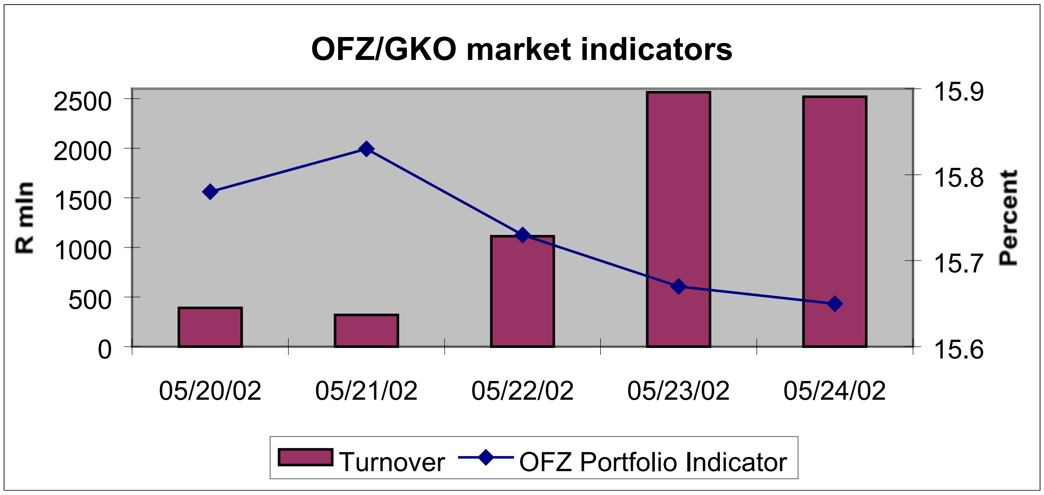




<u>Interest/Bond Market</u>

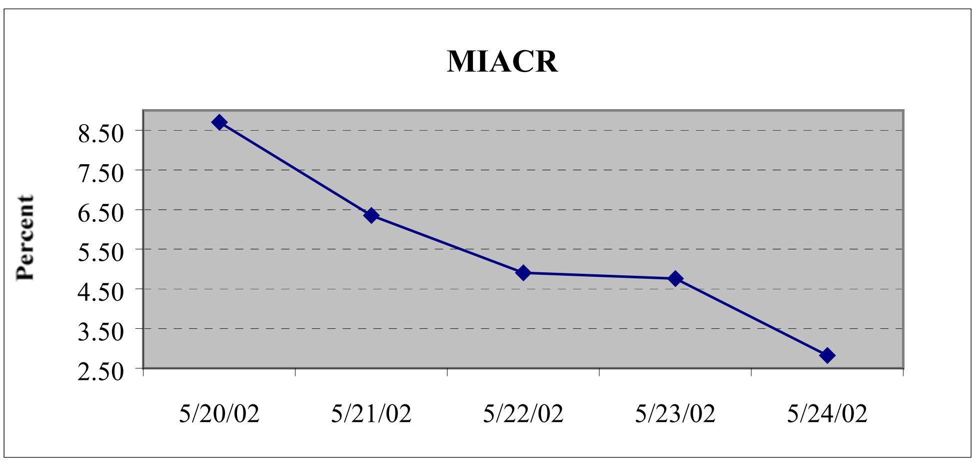
Bonds/Bills

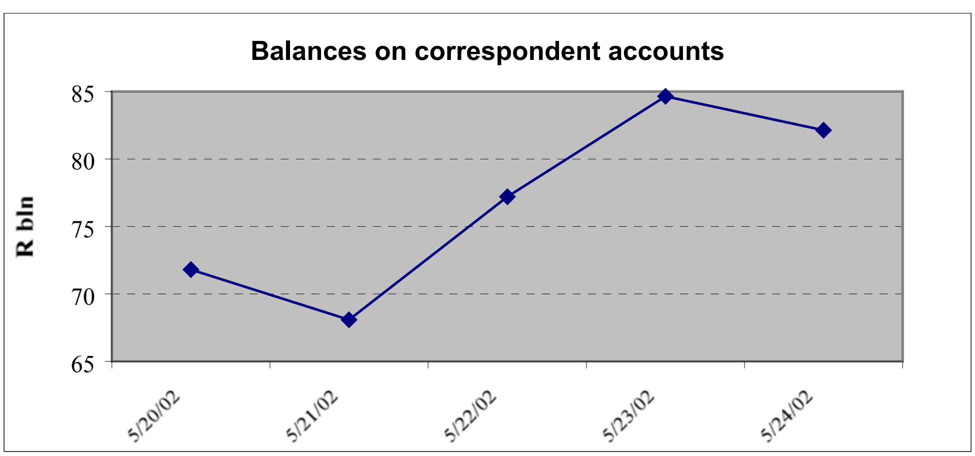
The recent redemption of a R10.5 billion OFZ issue was the major factor affecting the market last week. As had been forecast, the freed money resources were reinvested in the secondary market leading to a substantial increase of the trade volumes, as well as continuous slide of the yields of practically all issues. The GKO/OFZ market continued to rise in the first part of the following week given excess liquidity in money markets, however, this may change later in the week when tax payments are due.



Overnight rates

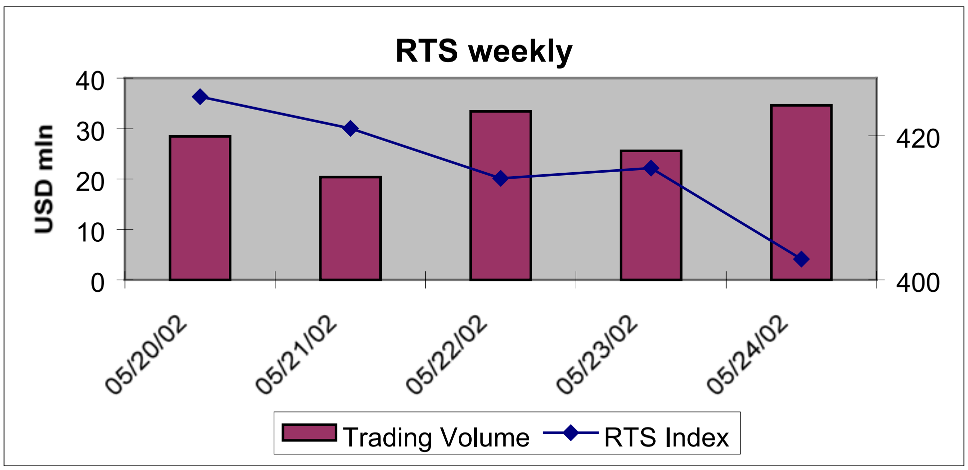
Balances on banks' correspondent accounts at the CBR remained on slightly above average levels during the week. Banks short-term ruble loan rates declined during the week reflecting an increase in ruble liquidity.

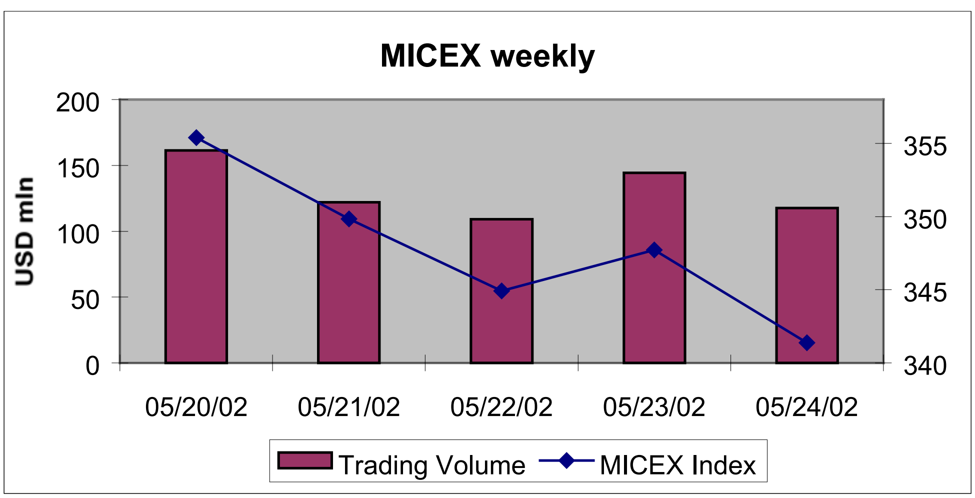


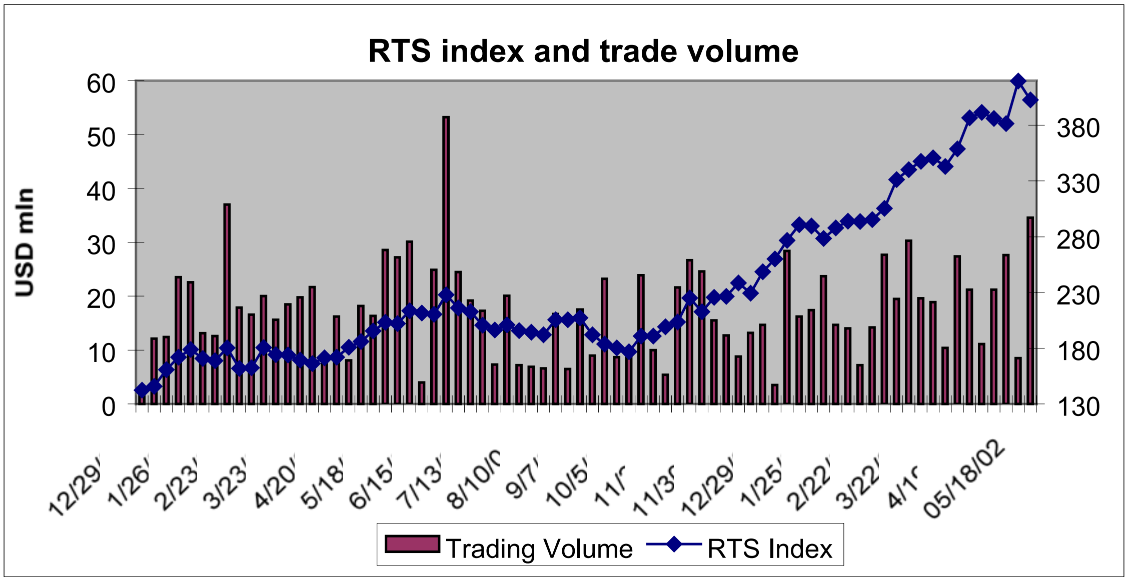


Stock Market

The market opened up by 1.36% (RTS) on Monday reaching the new highs of 425 points. Later on in the week, the market began to decline as a result of profit-taking (expected after reaching record-high levels) and on the news of downward correction of world oil prices. Trading volumes were above average, and by the end of the week the RTS index slid almost back to 400, the level reached in mid-May. For the week, the RTS index was down by 4% in dollar terms.



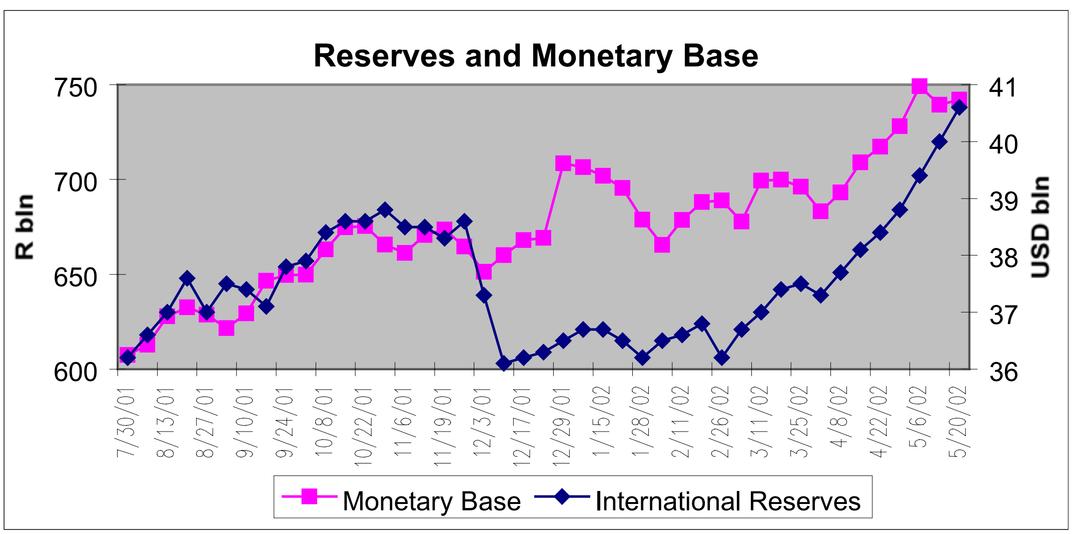




<u>International Reserves and Monetary Base</u>

International reserves continued to grow at a high pace last week and reached another record high of $40.6 billion, which is $600 million higher than a week before. Since the beginning of the year reserves have grown by $4.1 billion.

After shrinking for one week, the monetary base continued is upward climb, with the increase over last week of R2.8 billion ($90 million), and totaled R742.1 billion ($23.9 billion), according to the Central Bank.



Recommendations of the US - Russian Private Sector Banking Dialogue

We congratulate the Russian Government and Central Bank of Russia on their Joint Banking Strategy (JBS). It is an important first step in realizing the banking sector's potential to support growth in Russia's economy, but only if it is implemented effectively and re-enforced by necessary reforms in the financial, judicial, and business accounting areas.

The U.S.-Russia Banking Dialogue brings together the views of the private sector - large and small banks and their clients, both domestic and foreign. The group shares the goal of the JBS of stimulating growth and improving economic conditions while enhancing sound banking practices. To achieve this goal, we consider it of paramount importance to bring the quality of Russian banks to a point that they can establish productive relationships with the international banking system and among each other. Making Russia's banking system consistent with international banking norms must be an organizing principle when reforming the banking system.

Banks need reliable clients, including other banks. Clients need banks that can meet their financing needs and act as stable partners for business development. As market participants, we can draw attention to those reforms that will have the most impact. Our recommendations cover specific measures to implement the JBS and additional areas that require special attention. These include:

- Securing creditor rights by amending legislation in areas such as collateral enforcement, and increasing court independence and accountability.
- Rationalizing regulation and supervision while introducing deposit insurance. The goal is to reduce systemic risk, improve risk management at banks, and, at the same time, reduce the administrative burden on the banking system. Reforms include prompt adoption of the full set of Basel Committee norms, higher capital adequacy standards, and internationally accepted risk management tools.
- Promoting a level playing field for all participants by phasing out government and CBR ownership of commercial banks on a clear and ambitious timetable, enforcing anti-monopoly laws, and eliminating privileges and subsidies.
- Enhancing business opportunities for banks by enabling loan syndication, allowing for financial innovation, and eliminating unnecessary reporting burdens.
- Expanding credit in underserved regions and sectors such as small business by removing administrative barriers to bank expansion and targeting government programs.
- Increasing liquidity in the system and expanding the sources of long-term lending capital through legal and regulatory incentives, while preserving safety and soundness.
- Maximizing the transfer of international skills and resources through private bank contacts and training programs.
- Giving banks appropriate tools to fight money laundering and terrorist financing. The Government and CBR should not require commercial banks to implement non-commercial controls over customers, while in turn, banks should strictly comply with the law.

The participants of the Dialogue believe that recommendations 1, 8, 13, 18, 24, and 26 can be implemented expeditiously.

RECOMMENDATIONS

Increasing Trust and Reducing Risk in the Financial System

The perception of a risky banking system in Russia limits overall trust in Russia's economy. A high level of systemic risk dampens investment and makes banks less willing to provide credit, thus making credit more expensive.

1. Improve business practices: Managers in many banking institutions lack the managerial skills and knowledge of professional business ethics necessary to operate in an international competitive system. Simply adopting a code of ethics or new CBR regulation will not solve this problem. **The Banking Dialogue is prepared to establish a forum where Russian and foreign bankers can build new relationships, exchange experience, organize training and discuss new approaches to management, ethics and professional education.**

2. Prepare for restructuring of the system: We expect major structural changes in the banking sector with transition to international accounting standards, and raising minimum capital requirements and capital adequacy standards by 2004/2005. In the meantime, the potential still exists for systemic crisis. Bank restructuring in other transition economies has cost up to 10-20% of GDP. **The Russian government should immediately establish contingency plans for possible crisis and assign responsibility to a ministry or dedicated agency to determine financial and operational costs.**

3. Make the judicial system more reliable for banks: Banks in Russia do not lend as much as they could because they cannot be sure of enforcing their rights in court in a timely manner. The problem will require overall judicial reform but could be eased if courts better understood financial issues. **The government should establish training for judges who handle financial cases, possibly funded through U.S. or other technical assistance. Separating the first and second instance (appellate) courts from a single source of financing and administration should add to the competence and independence of the appellate court.**

4. Make collateralized lending safer: We commend the JBS's focus on better bankruptcy procedures, which should give stronger rights to collateralized lenders. **The government must ensure their elaboration and enforcement. The government should work with the Duma to introduce legislation so loans can be secured with domestic securities, cash, and receivables.**

5. Encourage adoption of internationally accepted financial tools: **The GOR should establish legal conditions to allow banks to manage financial risk using internationally accepted methods such as derivatives or repo (re-purchase) operations.** The current Civil Code does not properly protect creditor rights in a number

of kinds of transactions, including derivative contracts. It also prevents financial innovation that can make the system more efficient. **The government should work with the Duma to amend the Civil Code to ensure the legal protection of creditors in all internationally recognized types of transactions, assuming there is a contract between the parties. Operations not prohibited by law would thus be regulated according to international norms.** For example, moving to international norms for ruble letters of credit would facilitate international trade transactions.

6. <u>Allow banks to protect themselves from dirty money</u>: We support implementation of anti-money laundering legislation to improve confidence and trust among Russian and foreign banks and bring Russia's banking system up to international standards. However, banks must be able to control with whom they do business to control money-laundering risk. **The government should work with the Duma to change the Civil Code to allow banks to terminate a bank account agreement unilaterally (after proper notice) and to refuse to open accounts for clients they suspect of money laundering or terrorist financing.**

7. <u>Improve information exchange in the system:</u> Creating credit bureaus as envisaged in the JBS would be a positive step to improve bank information on clients, especially small and medium businesses, which will lower costs and increase lending levels. To ensure this, **the government should work with the Duma to change the law to allow banks to share client information with other banks on a limited and voluntary basis.**

8. <u>Focus banking supervision on real risks while reducing unnecessary compliance burdens:</u> Creating a more reliable, streamlined supervision regime is a necessary condition for bringing the sector up to international standards, and should be developed in tandem with deposit insurance. Implementation of JBS recommendations on supervision will be key, especially moving from form to substance, improving oversight of banks' risk management policies (including on the issue of concentrated lending and poor asset quality), and assuring proportionality of sanctions to offenses. Amendments to the law on the Central Bank should give the CBR the necessary authority and opportunity to reach these goals. Priorities in the supervisory area are the following:

- **The CBR should adopt Basel standards on banking supervision and internal control in full.**
- **The CBR should drastically streamline the licensing and registration process, which can be done without compromising higher standards for bank licenses.** Banks report that it can take two years to register increased capital, which clearly reduces incentives for bank capitalization and lending.
- **The CBR should rationalize and automate reporting requirements using the latest technology, including the Internet. The number of non-prudential reports should be decreased. A consultative group from the banking industry and CBR should be formed to review CBR reporting requirements, including currency control and other reporting, and recommend changes.**
- **An advisory program, including foreign bank compliance officials, auditors and supervisors should be established to give CBR inspectors exposure to the latest supervisory techniques.**

9. Coordinate the transfer to International Accounting Standards with additional measures: The move to IAS means that banks must comply with three accounting standards: Russian standards, IAS, and tax accounting. This decreases transparency and increases the compliance burden. **Before IAS is made mandatory, the CBR should harmonize its required accounting with tax accounting. The tax authorities and the Central Bank should move together towards IAS.**

Creating a Competitive Banking System

Private banks in Russia face an unlevel playing field when competing with state banks who benefit from implicit and explicit government subsidies in attracting deposits and lending to large customers. Leveling the playing field would make the entire sector more healthy and efficient.

10. Set a clear action plan with timeline for state bank divestiture: We applaud the government's plans to divest from state banks. However, **the government and CBR must formulate and implement plans that are more concrete, especially with respect to the future of Sberbank.**

11. Reduce state banks' anti-competitive behavior: In the near term **the government should apply strong anti-monopoly control over Sberbank to ensure that its pricing is on a level playing field with other banking institutions**. **Likewise, on deposit insurance, the level of requirements and costs should be the same for Sberbank as for all other participants, even if Sberbank is not immediately included in a new deposit insurance fund.** Banks owned or controlled by regional and municipal authorities have the same anti-competitive effect as federally-owned banks as a result of price subsidies and privileged access to government accounts and funds. **The Anti-Monopoly Ministry should enforce its rules on regional and local government banks to give private banks equal access to larger customers and government tenders.**

12. Enable private banks to compete for large customers through loan syndication: The current dominance of state banks means that companies needing big loans do not have a choice of domestic private banks. **The government should work with the Duma on changes to the Civil Code and other regulations to lay a stronger tax and legal basis for syndicated lending to allow private banks with less capital to compete for large customers. Legal, accounting tax and bankruptcy regulations should be adjusted to fit internationally accepted norms in cross-border syndicated loan transactions.**

13. Phase out CBR's ownership role in the banking system: There is a fundamental conflict of interest when the CBR owns banks that it supervises. Until CBR withdraws fully from the system, **all decisions on financial support for CBR-owned banks should be approved by authorities other than the Central Bank. The Government and CBR should designate such an authority.**

Increasing the economy's access to credit, especially long-term

A lack of long term funding is found throughout the Russian economy, with less than 10% of credit beyond three years duration. The problem is especially acute for SMEs and in the regions. Reducing the state banks' dominance over the deposit market and increasing banks' and companies' access to international capital, over time, will increase long-term funding, but other near-term measures are needed to reduce the cost and risk of

long-term lending.

14. Continue to reduce the administrative tax burden on banks and clients: An excessive administrative tax burden for banks and their clients still remains despite major improvements in tax legislation. For clients, the large number of bodies responsible for collecting taxes makes it difficult to obtain the number of certifications necessary to open bank accounts efficiently, thus reducing the deposit base. To reduce the administrative tax burden on banks, **special provisions in the tax code relating to banks should be updated to reflect new loan loss reserves and provisioning requirements of the Central Bank. The CBR should establish clear-cut rules allowing banks to write bad debts off the balance sheet according to their internal estimate of recovery chances, but in any case not later than the date a court declares the respective debtor bankrupt.**

15. Lower inefficient taxes and fees: Tax and fee changes can also spur growth in lending and reduce tax evasion. For example:

- **The current tax on cash sales of foreign currency should be eliminated, as has been proposed by the government**. With extremely low margins, the current tax simply drives foreign currency trade into the black market.
- The bond issuance tax is being lowered to 0.2% from 0.8%, but all bonds are taxed the same, regardless of maturity. **The new issuance tax rate should account for differences in bond maturity to create a level playing field for long and short-term issuances.**
- **The 1.5% fee for notarizing collateral should be lowered by a factor of 10.**
- **Discriminatory rules that, in contrast to all other businesses, do not allow banks to set-off VAT against receivables and payables should be abolished.**

16. Secure banks' rights to long-term deposits: The Civil Code gives clients the right to break term deposit contracts before maturity, thus negating them as a source of long-term funding. This law grew out of concern about access to funds during crisis, but the adoption of deposit insurance should mitigate this concern. **The Government and CBR should work with the Duma to change the Civil Code to allow banks to impose significant penalties for early withdrawal.**

17. Allow banks to use existing reserves and loan portfolios as security to generate liquidity: Safety and efficiency of the system would be enhanced if banks had access to a flexible, convenient and easy-to-use system of short-term financing, a common feature in most international banking systems. **The law should be changed to allow CBR to provide limited overnight refinancing to banks secured by required reserves held at the CBR.** Banks also may be encouraged to lend more and for longer term if, in extremis, they can generate liquidity from existing longer-term loans**. The CBR could establish a**

short or medium-term lending window for commercial banks, accepting as collateral publicly traded financial instruments that fulfill certain risk criteria.

18. Make setting up new licensing procedures, including opening branches, faster, easier and cheaper: **The CBR should establish clear, workable procedures for opening branches that are applied uniformly throughout the Russian Federation.** Now, regional central bank offices apply these standards differently and it can take up to six months to get permission to open a branch.

19. Target government support to bring long-term capital resources to specific sectors: In our opinion this could involve several initiatives:

- **Assist USG agencies such as Export-Import Bank, OPIC and others in marketing their products in Russia.**
- **Have certain state-owned banks act as "wholesale banks" for specific purposes (agriculture, mortgage, trade, and small enterprises) and channel this lending through other commercial banks. State-owned banks that could fulfill a specialized lending role could be Rosselhozbank (agriculture), Russian Regional Development Bank, and Vneshtorgbank (trade), for example.**
- **Expand on successful programs, such as the Enterprise Support Program run by the World Bank and Russian Ministry of Finance, that have demonstrated best practices in providing long-term capital through private banks.**

20. Establish clear terms for foreign bank participation in the Russian market: There are currently three ways for foreign banks to provide services to Russian clients: cross-border banking, branches, and subsidiaries. Russia recently began to open up the possibility for cross-border banking services and removed all restrictions to subsidiaries. The government must now consider whether to allow foreign branches or only foreign subsidiaries to operate in the Russian market. **Here, the government should consider the benefits to the economy of increased local access to long-term funding and cheaper services in case of branching, versus less competitive pressure for domestic banks if only foreign subsidiaries are allowed.** Our group has not come to consensus on this issue.

21. Remove barriers to mortgage lending: The special case of mortgage lending requires a better legal basis for eviction in the case of non-payment, as well as access to long-term funding in rubles**.** Without long-term funds, the risks of mortgage lending are generally perceived as too high given an average source of funds of less than six months for loans of 10-year duration.

- **Legislation should be changed to allow reasonable rights of foreclosure. This is currently not allowed if a family has a child.**
- The JBS proposal to create a secondary market for mortgages is a positive step and could eventually draw pension and insurance funds into the mortgage market. However, the primary market for mortgage lending must be created first. **The government should create a market for long-term government bonds that would provide a benchmark for long-term ruble loans, including mortgages.**

22. Reduce cash transactions in the economy: Russia's financial system is made inefficient by the high rate of cash transactions. This is primarily related to structural problems in the economy that drive transactions out of banks and financial markets and into the unofficial economy. Nevertheless, **the government should encourage non-cash settlements by implementing legislation for easy-to-use, effective electronic signatures that meets international norms, moving toward electronic payment of utility and other bills, and creating incentives for credit card use.**

SME Financing Issues

SMEs are essential to economic growth and employment in Russia. Although administrative barriers hinder growth in this sector, access to financing is a critical barrier to their development. High administrative costs in the banking system have a particularly detrimental effect to lending to small business. Most Russian banks count on large clients to cover fixed costs, but this limits where and how they can lend to small business. However, experience has shown that small businesses are some of the best clients. If the government is serious about supporting small business, it should take an active role in reducing costs for lending institutions doing business with SMEs, particularly in under-served areas. Expanding the geographic scope of private banks and credit cooperatives can also help draw savings into the system, increasing the resource base for SME lending.

23. Increase the capacity of bank representative offices and credit cooperatives to increase lending in underserved communities:.

- Opening a branch costs three times more than opening a representative office. **Representative offices should be allowed formally to conduct preliminary lending operations directly, such as preparing the client to submit a loan application or storing paperwork on site**. Such a reform would require adjustments in the Central Bank's supervisory work and in local tax administration rules. Streamlining the process for setting up new branches (see recommendation 18) would also enhance credit to SMEs in underserved areas.
- **Encourage the development of non-bank financial institutions participating in microfinance. Concrete steps would include supporting the passage of legislation currently in the Duma "On Credit Cooperatives" and engaging in constructive dialogue with non-bank financial institutions on the development of the sector to effectively serve the needs of the smallest SME clients.** However, non-bank institutions that take deposits should generally be subject to the same supervisory norms as banks. If legal and administrative issues are properly solved, credit cooperatives can become clients and partners of banks by acting as a bridge to groups of small clients and savers.
- **Small banks, including credit unions, which do not meet the minimum capital standard of 5 million euros when it is phased in 2007 should be allowed to continue to conduct operations for small and medium-sized business if they are properly managed, supervised, and practice sound banking.**

24. Improve data on the small business sector: Banks, like any business, need good market data in order to expand. Currently, data on small business is inadequate for the complex business decisions that banks need to make. Instead, each bank must undertake complex, expensive marketing research to make the decision to invest in new markets. **The government should gather and disseminate better demographic and economic data on small business, which will ease the burden on banks that want to expand their lending.**

25. Target government support for lending to SMEs: The government must maximize the efficiency of the resources that it spends for small business development, which is best done through risk sharing with banks rather than interest rate subsidies. SME industry representatives agree that high interest rates are not the barrier to SME lending in Russia.

- **A government program should be created to provide guarantees covering up to 50% of banks' small business loan portfolios. This guaranteed debt could then be securitized as a source of long term refinancing.** Assuming a loan loss rate of no more than 2 percent, which is consistent with current experience, each $10 million of government expense (excluding administrative costs) could leverage up to $1 billion in new loans to small business.
- Another vehicle could be long-term loans to banks with a proven track record in lending to small business, distributed on a competitive basis. Banks complain that demand for loans is greater than supply of funds, and the current 1-3 month source of funds on the inter-bank market cannot sustain banks' business plans. **The Government should consider extending ruble credit lines of over six months duration to banks active in SME lending**.

26. Support dissemination of best practices in SME lending: Lending to SMEs requires specialized systems and knowledge that many Russian banks lack. **The government could be a catalyst for disseminating best practices on small business lending by partially financing training programs for banks run by the current leaders in the SME lending industry, such as the EBRD's Russia Small Business Fund.**

27. Reduce the cost of settling claims on SME loans: Banks would lend more to small businesses if there were more effective dispute resolution mechanisms for small claims and the legal status of sole proprietors were clarified. Currently, the time and cost needed to pursue claims through courts outweigh the benefits and enforcing claims on sole proprietors faces legal ambiguities. **The government should establish expedited court procedures for small claims.**

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which

exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.